No. 3183

In the United States Circuit Court of Appeals

For the Ninth Judicial Circuit

AMERICAN SURETY COMPANY OF NEW YORK, a corporation,

Appellant,

vs.

BELLINGHAM NATIONAL BANK, THE CITY OF BELLINGHAM, MORSE HARDWARE COMPANY, WHIDBY ISLAND SAND & GRAVEL COMPANY, MORRISON MILL COMPANY, K. SAUSET, CAINE GRIMSHAW COMPANY, JOHN BIEKERT, NORMAN TRANSFER COMPANY, FRANK MIDDLESTADT, JOHN KASTNER, SAM SEIVER, BELLINGHAM CONCRETE WORKS, W. M. SEEGER, THOMAS M. LYNN and M. J. WILLIAMS, co-partners as Lynn & Williams,

Appellees.

APPEAL FROM THE DISTRICT COURT OF THE UNITED STATES FOR THE WESTERN DISTRICT OF WASHINGTON, NORTHERN DIVISION

HON. JEREMIAH NETERER, Presiding

Brief of the American Surety Company of New York, Plaintiff and Appellant

HASTINGS & STEDMAN,
KELLOGG & THOMPSON,
Solicitors for Appellant

LIVINGSTON B. STEDMAN, Counsel
Office and Post Office Address, 64 Haller Bldg., Seattle, Washington

THE ARGUS PRESS SEATTLE

FILED
AUG 10 1918

No. 3183

In the United States Circuit Court of Appeals

For the Ninth Judicial Circuit

AMERICAN SURETY COMPANY OF NEW YORK, a corporation,

Appellant,

vs.

BELLINGHAM NATIONAL BANK, THE CITY OF BELLINGHAM, MORSE HARDWARE COMPANY, WHIDBY ISLAND SAND & GRAVEL COMPANY, MORRISON MILL COMPANY, K. SAUSET, CAINE GRIMSHAW COMPANY, JOHN BIEKERT, NORMAN TRANSFER COMPANY, FRANK MIDDLESTADT, JOHN KASTNER, SAM SEIVER, BELLINGHAM CONCRETE WORKS, W. M. SEEGER, THOMAS M. LYNN and M. J. WILLIAMS, co-partners as Lynn & Williams,

Appellees.

APPEAL FROM THE DISTRICT COURT OF THE UNITED STATES FOR THE WESTERN DISTRICT OF WASHINGTON, NORTHERN DIVISION

HON. JEREMIAH NETERER, Presiding

Brief of the American Surety Company of New York, Plaintiff and Appellant

HASTINGS & STEDMAN,
KELLOGG & THOMPSON,
Solicitors for Appellant

LIVINGSTON B. STEDMAN, Counsel
Office and Post Office Address, 64 Haller Bldg., Seattle, Washington

THE ARGUS PRESS SEATTLE

In The United States Circuit Court of Appeals

For the Ninth Judicial Circuit

No. 3183.

AMERICAN SURETY COMPANY OF NEW YORK, a corporation,

Appellant,

vs.

BELLINGHAM NATIONAL BANK, THE CITY OF BELLINGHAM, MORSE HARDWARE COMPANY, WHIDBY ISLAND SAND & GRAVEL COMPANY, MORRISON MILL COMPANY, K. SAUSET, CAINE GRIMSHAW COMPANY, JOHN BIEKERT, NORMAN TRANSFER COMPANY, FRANK MIDDLESTADT, JOHN KASTNER, SAM SEIVER, BELLINGHAM CONCRETE WORKS, W. M. SEEGER, THOMAS M. LYNN and M. J. WILLIAMS, co-partners as Lynn & Williams,

Appellees.

APPEAL FROM THE DISTRICT COURT OF THE UNITED STATES FOR THE WESTERN DISTRICT OF WASHINGTON, NORTHERN DIVISION

HON. JEREMIAH NETERER, Presiding

Brief of the American Surety Company of New York, Plaintiff and Appellant

---

STATEMENT OF THE CASE.

The City of Bellingham, Washington, made two contracts with the defendants, Moran Bros., for street improvements; one to improve Maryland Street, dated July 29, 1916, at a cost of Five Thou-

sand Eighty-seven Dollars and Eighty Cents ($5,087.80) (Finding of Fact II, Record 109) and the other to improve Iowa Street, dated September 22, 1916, at a cost of Three Thousand One Hundred and Thirty-five ($3,135.00) Dollars (Finding of Fact X, Record 113).

To secure the faithful performance of these contracts and the payment for labor and material entering into the work, Moran Bros. were compelled by the City of Bellingham to give bonds for the full amount of each contract; and the plaintiff and appellant, the American Surety Company of New York, became surety on both of said bonds. The Maryland Street bond was dated July 27, 1916, and the Iowa Street bond was dated September 20, 1916 (Finding III, Record 110; Finding XI, Record 113).

Though the work under Maryland Street contract was completed the city yet holds the full amount of the contract price and the price of the extras, amounting to Five Thousand Seven Hundred and Twenty-one ($5,721.00) Dollars (Finding IV, Record 110), and the city has paid nothing on the Iowa Street contract but retained as admitted due thereon, Two Thousand Seven Hundred and Seventy-eight Dollars and Five Cents ($2,778.05) (Finding XII, page 113), and the American Surety Company has advanced for the completion of the Iowa Street contract Five Hundred and Forty-eight Dollars and Fifty-four Cents ($548.54) (Finding XIV, Record 114).

Claims have been filed for material and labor against the Maryland Street bond aggregating Three Thousand Five Hundred and Ninety-two Dollars and Thirty-six cents ($3,592.36) (Finding V, Record 110) and the Bellingham National Bank made advances to the Moran Bros. for the Maryland Street work—all of which excepting One Hundred and Fifty ($150.00) Dollars was used in prosecuting said work—amounting to Three Thousand Thirty-three Dollars and Fifteen Cents ($3,033.15) (Finding VI, Record 111).

Like claims have been filed against the Iowa Street bond for Two Thousand Three Hundred and Ten Dollars and Fifty-two Cents ($2,310.52) (Finding XIII, Record 114), and the bank has advanced to the Moran Bros. to prosecute the Iowa Street contract, all of which was so used excepting One Hundred ($100.00) Dollars, the sum of One Thousand Seven Hundred and Eighty-one Dollars and Seven Cents ($1,781.07) (Finding XV, Record 114).

The bank took assignments from the Moran Bros. or orders on the city comptroller to secure these advances; on the Maryland Street contract September 11, 1916 (the contract was made July 29th and the plaintiff's bond executed July 27, 1916) (Finding VI, Record 111), and on the Iowa Street contract on October 20, 1916 (contract made September 22nd, plaintiff's bond executed September 20th) (Finding XV, Record 115).

The contracts for the performance of this

work between the Moran Bros. and the City authorized the City of Bellingham to "withhold any and all payments under this contract until satisfied that such wages, assistance and materials have been fully paid for." (Record, page 27, bottom and top of page 28.)

The bank claims to have paid the Morse Hardware Company One Hundred and Thirty-three Dollars and Twenty-five Cents ($133.25) (Finding VIII, Record 112), yet the court, over the plaintiff's and appellant's objections (Record 132) allowed the claim to Morse Hardware Company (Record 128).

The bank did not file any claims with the City of Bellingham (Finding IX, Record 113, and Finding XVI, Record 116).

The plaintiff and appellant contests none of these claims for labor and material, excepting the Morse Hardware Company's claim on Maryland Street for One Hundred and Thirty-three Dollars and Twenty-five Cents ($133.25). The only substantial question presented to Your Honors is, whether the bank is entitled to have its claims paid in full by virtue of its assignments from the Moran Bros. or whether the American Surety Company has the prior equity to have the funds or warrants now in the hands of the City of Bellingham, devoted to the payment of the claims for labor and materials that have been duly filed with the city comptroller before any payment is made to the Bellingham National Bank on its assignments from Moran Bros.

SPECIFICATION OF ERRORS.

FIRST: The decree is erroneous because from the findings the assignments to the Bellingham National Bank of the warrants and the improvement bonds from the contractors were subsequent in date to the execution of the bond of the plaintiff and appellant, American Surety Company. The American Surety Company's equity in the funds in the hands of the City was superior in point of time.

SECOND: The decree is erroneous because, under the law and the findings of the court, the right of subrogation of the American Surety Company of New York to the rights of the claimants who furnished labor and material on the public works, and also to the rights of the City of Bellingham against the funds in the hands of the City, is superior to the right of the contractors, Moran Bros., or their assignee, Bellingham National Bank.

THIRD: The decree is erroneous because, from the findings, it appears that all moneys advanced by the Bellingham National Bank were advanced long after the execution of the bonds.

FOURTH: Said decree is erroneous in favor of the Bellingham National Bank as against the American Surety Company of New York, because the Bellingham National Bank was a mere volunteer and under no obligation to advance any moneys to the Moran Bros.

FIFTH: The decree is erroneous because, under the contract for the performance of said

work, the claimants, who filed their claims against the contractors and said bond, are entitled to have their payments made out of the contract price, and such right is prior to any claim of the Bellingham National Bank.

SIXTH: The decree is erroneous because the plaintiff and appellant, American Surety Company of New York, under its contract of suretyship, is entitled to have the claims that are liens upon the bond and upon the fund in possession of the City of Bellingham paid before the assignments of the contractors to the Bank are recognized.

SEVENTH: The decree is erroneous in that it did not direct that the funds in the hands of the City should be devoted, first, to the payment of all claims filed against said contractors and said bonds, and the balance, if any, paid over to the Bellingham National Bank in the place of giving the preference, as given in said decree, to the said Bellingham National Bank.

EIGHTH: The decree is erroneous because it appears from the findings that the Morse Hardware Company had been already paid, by the Bellingham National Bank, its claim of $133.25 filed against the Maryland Street improvement, notwithstanding which the Court ordered it again to be paid.

ARGUMENT.

With the exception of the question of the claim of the Morse Hardware Company, on the Maryland Street contract for $133.25, which the Bell-

ingham National Bank had paid, and concerning which there is no argument necessary, the sole question to present to Your Honors is whether the surety upon the contractors' bond for public work —executed at or before the time the contract was let and a part of the original contract, which surety is bound to pay the claims duly filed with the city officials for labor and materials—is entitled to have the funds in the hands of the City devoted to the payment of those claims in preference to the claims of the Bellingham National Bank, assignee of the contractors, who, if they had made no assignment, would have been entitled to no payment before the labor and materials were paid for.

SURETY IS ENTITLED TO SUBROGATION TO RIGHTS OF THE CITY AND LABOR OR MATERIAL CLAIMANTS.

The question is not a new question in this Circuit. The leading Federal case is that of *Prairie State National Bank vs. United States*, 164 U. S. 227, 41 L. Ed. 412. In this case, the Court, speaking through the then Mr. Justice White (now Chief Justice) says:

> "The Prairie Bank asserts an equitable lien in its favor, which it claims originated in February, 1890, and is therefore paramount to Hitchcock's lien, which it is asserted arose only at the date of his advances. The claim of Hitchcock, on the other hand, is that his equity arose at the time he entered into the contract

of suretyship, and therefore his right is prior in date and paramount to that of the bank. * * *

"That Hitchcock, as surety on the original contract, was entitled to assert the equitable doctrine of subrogation is elementary. That doctrine is derived from the civil law, and its requirements are, as stated in *Aetna L. Ins. Co. v. Middleport*, 124 U. S. 534 (31:537): '(1) That the persons seeking its benefits must have paid a debt due to a third party before he can be substituted to that party's rights; and, (2), that in doing this he must not act as a mere volunteer, but on compulsion, to save himself from loss by reason of a superior lien or claim on the part of the person to whom he pays the debt, as in cases of sureties, prior mortgages, etc. The right is never accorded in equity to one who is a mere volunteer in paying a debt of one person to another.' See authorities reviewed at pp. 548 (542) *et seq.*

"As said by Chancellor Johnson in *Gadsen v. Brown, Speers*, Eq. 38, 41 (quoted and referred to approvingly in the opinion in *Aetna L. Ins. Co. v. Middleport*, just referred to), 'the doctrine of subrogation is a pure unmixed equity, having its foundation in the principles of natural justice, and from its very nature never could have been intended for the relief of those who were in any condition in which

they were at liberty to elect whether they would or would not be bound and, as far as I have been able to learn its history, it never has been so applied. If one with the perfect knowledge of the facts will part with his money, or bind himself by his contract in a sufficient consideration, any rule of law which would restore him his money or absolve him from his contract would subvert the rules of social order. It has been directed in its application exclusively to the relief of those that were already bound who could not but choose to abide the penalty.

"Under the principles thus governing subrogation, it is clear whilst Hitchcock was entitled to subrogation the bank was not. The former in making his payments discharged an obligation due by Sundberg for the performance of which he, Hitchcock, was bound under the obligation of his suretyship. The bank, on the contrary, was a mere volunteer, who lent money to Sundberg on the faith of a presumed agreement and of supposed rights acquired thereunder. The sole question, therefore, is whether the equitable lien, which the bank claims it has, without reference to the question of its subrogation, is paramount to the right of subrogation which unquestionably exists in favor of Hitchcock. In other words, the rights of the parties depend upon whether Hitchcock's subrogation must be considered as

arising from and relating back to the date of the original contract, or as taking its origin solely from the date of the advance by him.

"A great deal of confusion has arisen in the case by treating Hitchcock as subrogated merely 'in the rights of Sundberg & Co.' in the fund, which, in effect, was saying that he was subrogated to no rights whatever. Hitchcock's right of subrogation, when it became capable of enforcement, was a right to resort to the securities and remedies which the creditor, the United States, was capable of asserting against its debtor, Sundberg & Company, had the security not satisfied the obligation of the contractors, and one of such remedies was the right based upon the original contract to appropriate the 10 per cent retained in its hands. * * *

"Applying the principles which are so clearly settled by the foregoing authorities to the case at bar, it is manifest that if the transaction in February, 1890, by which the Prairie Bank acquired its alleged lien on the fund possessed the effect contended for by the bank, it would necessarily operate to alter and impair rights acquired by the surety under the original contract.

"Sundberg & Company could not transfer to the bank any greater rights in the fund than they themselves possessed. Their rights were subordinate to those of the United States

and the sureties. Depending, therefore, solely upon rights claimed to have been derived in February, 1890, by express contract with Sundberg & Company, it necessarily results that the equity, if any, acquired by the Prairie Bank in the 10 per cent fund then in existence and thereafter to arise was subordinate to the equity which had, in May, 1888, arisen in favor of the surety Hitchcock. It follows that the court of claims did not err in holding that Hitchcock was entitled to the fund and its judgment is therefore affirmed."

We have quoted thus largely from the case of *Prairie State National Bank vs. United States* because that case is the leading authority upon the question involved in this action.

It is true that that case is distinguishable from the case at bar because in the case of *Prairie State National Bank vs. United States*, a Federal contract was involved which expressly forbid the assignment of any sums due thereon, but the words of the court in its opinion, with reference to the rights of subrogation, have been quoted with approval and followed in other cases, to which we will call Your Honors' attention.

A point almost identical with the case at bar was raised in the case of *Henningsen v. United States Fidelity & Guaranty Co. of Baltimore, Md.*, 143 Fed. 810. Henningsen, the contractor, completed the work but failed to pay for all the materials and labor. Whereupon the surety company

commenced a suit, as plaintiff has in this case, against the contractor and each of the persons to whom the contractor was indebted, and the Honorable Circuit Court of the United States for the Northern Division of the Western District of Washington entered an order directing the payment of the penalty of the bond to the creditors pro rata and the release of the surety. Thereupon, an action was brought to prevent the quartermaster from dispensing to Henningsen, or to the officers of the bank—who advanced Henningsen money to carry on the contract—the unpaid portion of the contract price, and the Court held that the equity of the surety company was superior to that of the bank therein. Judge Ross, speaking for the Circuit Court of Appeals, says, at page 813:

> "Whatever equity, if any, the bank had to the fund in question, arose solely by reason of the loans it made to Henningsen. Henningsen's surety was, upon elementary principles, entitled to assert the equitable doctrine of subrogation; but it is equally clear that the bank was not, for it was a mere volunteer, and under no legal obligation to loan its money. *Prairie State Bank v. United States, supra; Insurance Company v. Middleport*, 124 U. S. 534, 8 Sup. Ct. 625, 31 L. Ed. 537; *Sheldon on Subrogation*, Sec. 240.
>
> "Where, as in the *Prairie State Bank* and the *Rundle* cases, *supra*, the surety is compelled to make good the default of his principal

as respects the government, the surety is, as was distinctly held in those cases, entitled to be subrogated to the rights of the government. Upon precisely the same principle the surety is entitled to be subrogated to the rights of the laborers and materialmen, where, as in the present case, it is compelled by reason of the obligations of the bond to pay them for labor and material because of the default of its principal. That right of subrogation relates back, as was held by the Supreme Court in *Prairie State Bank v. United States, supra,* to the time the contract of suretyship was entered into. See, also, *First National Bank of Seattle v. City Trust Safe Deposit Surety Co. et al,* 114 Fed. 529, 52 C. C. A. 313; *Richards Brick Co. v. Rothwell,* 18 App. D. C. 516."

This case was affirmed by the United States Supreme Court in 208 U. S. 404, 52 L. Ed. 547, in which Mr. Justice Brewer, after quoting from *Prairie State Bank v. United States,* said:

"It seems unnecessary to again review the authorities. It is sufficient to say that we agree with the views of the circuit court of appeals, expressed in its opinion, in the present case.

" 'Whatever equity, if any, the bank had to the fund in question, arose solely by reason of the loans it made to Henningsen. Henningsen's surety was, upón elementary principles,

> entitled to assert the equitable doctrine of subrogation, but it is equally clear that the bank was not, for it was a mere volunteer, and under no legal obligation to loan its money."

In *Hardaway & Prowell v. National Surety Co.*, 150 Fed. 465, it appeared that the assignee of a public contract partially completed it. There was a portion of the contract price held back by the Government. The contractor applied to the plaintiffs in the action for financial assistance, which was furnished, and the work was completed. Whereupon, plaintiffs in the action contended that, having an assignment of the funds in the hands of the Government from the contractor, they were entitled to payment prior to the claims of those who had furnished materials before the default, and prior to the right of the surety company to have the funds in the hands of the Government devoted to the payment of the claims. Part of the money in the hands of the Government had been earned prior to the default. The Court, speaking through Judge Lurton, then Circuit Judge, afterwards a member of the Supreme Court of the United States, said:

> "The attitude of Hardaway & Prowell as mere lenders of money is not, in substance, changed because that money was used in paying for labor and materials. Nor is the character of the claim, in its essence, changed by presenting it in the form of an account for the labor and materials which was procured

by its application. Manifestly, if the money had been loaned to Coyne under the express agreement that he was to use it in supplying labor and materials to be used in this work, and it was so used, the debt would still be a debt for money advanced, and not a debt for labor and materials, though every dollar was so applied. The same result must follow if Hardaway & Prowell, as mere superintendents, or managers for Coyne, used the money advanced by them in paying for like supplies. In both hypotheses the labor and materials would be supplied by Coyne, although the money which paid for them had been advanced by the appellants. Would a bank lending money to Coyne to be used by him in carrying out this contract be entitled to the protection of such a contractor's bond simply because the money was to be used, and was, in fact, used, in paying for labor and materials which were used in the work? If not, how much stronger is the equity of appellants even if they themselves used the money in paying for labor and materials which went into the work, if, in so applying it, they were merely acting as the agents or superintendents of Coyne? Money loaned would not be labor and materials. The labor hired and the persons actually supplying them with labor and materials might be protected as persons furnishing labor and materials to them as sub-contractors, or as mere

superintendents standing for and representing Coyne as a principal or subcontractor. But as mere agents for Coyne advancing money to him or for him, by paying for labor and materials supplied by others, they would not be subcontractors nor persons supplying subcontractors with labor and materials. *Prairie State Bank vs. United States*, 164 U. S. 227, 252, 17 Sup. Ct. 142, 41 L. Ed. 412. One who lends money to keep a broken-down railroad in operation and to pay for labor and necessary supplies has never been regarded as entitled to the equitable lien accorded to those who actually supply labor and materials to keep the road going. *Morgan's Louisiana, etc., Ry. Co. v. Texas Central Ry. et al.*, 137 U. S. 171, 11 Sup. Ct. 61, 34 L. Ed. 625; *U. S. Trust Company v. Western Contract Co.*, 81 Fed. 454, 26 C. C. A. 472. Money borrowed and used to pay labor claims entitled the lender to no preference in the absence of an assignment of the claims. *Theobald v. Hammond*, 133 Fed. 525, 66 C. C. A. 496."

This case was affirmed by the Supreme Court of the United States in 211 U. S. 550, 53 L. Ed. 321, in which the Court holds, speaking through Mr. Justice Day, at page 561:

"The right of the surety to be subrogated had attached to the fund, and was superior to any rights which Hardaway and Prowell had as assignees of Coyne. *Prairie State National*

Bank v. United States, 164 U. S. 227", etc.

In the case of *Title Guaranty & Surety Co. v. Dutcher*, 203 Fed. 167, Judge Cushman, one of the judges of the District Court for the Western District of Washington, applied to a state contract (not federal) the principles announced in Prairie State Bank, and in the Henningsen case and the Hardaway & Prowell case, all of which applied to Federal contracts. In that case, the contractor defaulted on the work and left unpaid bills for labor and material. In the prosecution of the work he had borrowed certain money and had given to the lender assignment of the bonds or warrants to be issued by the city, as was given to the Bank in this case. Judge Cushman says, at page 169:

> "The question thus presented is whether the right of the contractor's surety, or that of the contractor's assignees to the bonds and funds held by the city on account of the contract, is superior. This point is concluded in this circuit in favor of complainant by *First National Bank v. City Trust, etc.*, 114 Fed. 529, 52 C. C. A. 313; *Henningsen v. U. S. F. & G. Co.*, 143 Fed. 812, 74 C. C. A. 484; *Id.*, 208 U. S. 404, 28 Sup. Ct. 389, 52 L. Ed. 547. The following cases are to the same effect: *Prairie State Bank v. U. S.*, 164 U. S. 227, 17 Sup. Ct. 142, 41 L. Ed. 412; *Hardaway & Prowell v. National Surety Company*, 150 Fed. 465, 471, on petition for rehearing at 473, 80 C. C. A. 283. The complainant will be

allowed interest at the legal rate from the actual dates of the payments made by it for the completion of the contract, and for the unpaid labor and material claims which it satisfied. These dates are not disclosed in the statement of facts. If the bonds of the city are already issued and bearing interest, allowance will be made so as to only allow complainant interest at the legal rate upon its payments."

In the case of *First Nat. Bank of Seattle v. City Trust, Safe Deposit & Surety Co.*, 114 Fed. 529, the Circuit Court of Appeals for this Circuit held that the surety company was entitled to subrogation for all amounts unpaid without consideration of the percentage to be retained under the contract in preference to the assignee of contractors. In that case, the contractor entered into a contract with the City of Seattle to do certain paving. They applied to the First National Bank of Seattle for a loan of money to enable them to carry out their contract and accompanied their application with a promise to provide a reliable surety company bond to the city and to assign to the bank all moneys, bonds and warrants that should become due from the city under the contract for the months of August, September, October and November, 1900. Upon these conditions, the bank promised to loan and advance the necessary money. Your Honors will notice that this was a stronger case in favor of the Bank than the case at bar, because there is no contention in the case at bar that there was any agree-

ment for the borrowing of the money prior to the giving of the bond by the surety company, or that there was any expressed promise to make an assignment of the warrants and bonds prior to the loaning of the money, and the lending of the money and the assignment of the bonds in this case were subsequent, by quite a length of time, to the filing of the bonds by the surety company. The court, speaking through Judge Gilbert, says, at page 532:

> "Applying these principles to the present case, it is clear that the lien of the surety company upon all funds now retained in the posession of the city, and applicable upon the contract, had its inception at the time when it entered into the contract of suretyship, and that subsequent to that date the contractors, McCauley & Delaney, had no power to create a lien upon the payments to be made by the city, and make it paramount to the lien of the surety. That the right of the bank in this instance is subsequent to the surety's lien is not to be questioned. The arrangement which is said to have been made between the bank and the contractors just prior to the execution of the bond cannot affect the rights of the surety. That arrangement, so far as the pleadings inform us, was not in the form of a binding agreement, and was not obligatory upon either party thereto; and, if it were, it could not take precedence of the lien of the surety by virtue of the bond which it entered into simultaneously with the execu-

tion of the contract, unless it was known and assented to by the surety. There is no intimation that the surety assented to or had notice of such an agreement. One who becomes a surety for the principal upon such a contract as is disclosed in this case may not be deprived of his lien by the secret contract or agreement into which his principal may have entered. By abandoning the contract the contractors lost the right to compel the city to pay them any sum whatever on account of the work which they had done. Their assignee, the bank, stood in no better position than they. The city undoubtedly had the right to declare the contract and all unpaid sums which it had promised to pay thereunder forfeited. That it had this right is not disputed, but it is said that the city has not exercised it, and that, therefore, the right cannot avail the surety. But the true inquiry is, not what has the city done, but what had it the right to do? It had the right, if it had itself assumed the completion of the abandoned work, to retain for its own protection not only the stipulated 30 per cent., but all sums then due or earned under the contract, and no assignment by the contractors could defeat that right. Among the obligations of the contractors was included the duty to pay all claims for work, labor and material. The surety, by the terms of its bond, had guaranteed that the contractors would pay 'all just claims for work, labor, or material furnished in

the execution of the contract'. The surety's obligation to pay liens and claims outstanding when the contract was abandoned was not limited in extent to the reserved 30 per cent. of the money then earned by the contractors, but it included the full sum of the unpaid claims, amounting to $3,161.38. In the Prairie State Bank case the court expressly declared that the right of Hitchcock, the surety, was not limited to the 10 per cent. reserved, but that it was a right to 'resort to the securities and remedies which the creditor, the United States, was capable of asserting against the debtor, Sundberg & Co.' So, in the case before the court, when the surety assumed the burden of the contract, it stood in the position of the city, so far as the unpaid stipulated sums under the contract were concerned, and it acquired the city's right so far as it might be necessary to resort to the same to reimburse it for all its outlay in completing the work. We think the right of the surety company went that far, and no farther; and if it appeared upon its own bill herein, or in that of the intervenor that the money of the latter so advanced to the contractors under its agreement went into the improvement, so that the surety company acquired the benefit thereof, and availed itself of the same, and thereby acquired, on the completion of the contract, a profit,—or, in other words, if the moneys which are now retained by the city, if paid to the surety com-

pany would more than repay it the total amount of its expense incurred in completing the contract,—equity would require that the excess be paid to the bank, rather than to the surety. The right of subrogation has its origin not in contract, but in equity, and it goes no farther than the strict demands of equity and justice demand." * * *

"Counsel for the appellant cite and rely upon the decision of the Supreme Court of the State of Washington in *Dowling v. City of Seattle*, 22 Wash. 592, 61 Pac. 709,—a decision which it may be conceded announces a doctrine directly at variance with that of *Prairie State Nat. Bank v. U. S.* In the Dowling case it was held that orders drawn by a contractor on sums to become due on a contract with the city carried an equitable assignment of the fund, and, being valid when made, they were not rendered invalid by the default of the contractor, or by the assumption of the contract by the surety. The argument of the court was that, inasmuch as the city asserted no claim of right in the fund, there existed no right to which the surety could be subrogated; and that, as the contractor could not justly claim that his own assignments were invalid, neither could his bonsdmen, who had assumed the performance of the contract, so claim. The decision in that case does not involve, and neither does the present case, so far as the fore-

going discussion goes, involve, any question of the construction of a provision of the charter of the city of Seattle, or of the constitution or the statutory law of Washington. That decision, therefore, does not become a precedent which we are bound to follow."

And again Judge Cushman applied the same principles in the case of *Columbia Digger Co. v. Rechtor*, 215 Fed. 618, where the court held that the sureties upon a bond for the construction of a public improvement were equitably entitled to have the installments of the contract price paid by the municipality applied to the payment of bills for material and that materialmen receiving such money were bound to make application of payments upon materials furnished for the particular contract. The Court says, at page 630:

> "It is contended that the sureties had no equity in this money. The rule has been laid down in this circuit, under a statutory bond, similar to the one in question, that the materialman has a lien (an equitable lien) upon the funds in the hands of the city, not limited to the percentage retained under the terms of the contract, and that the surety who, upon the failure of his principal, discharges the claim of the materialman has a like lien by subrogation, superior to that of his principal's assignee. *First Nat'l Bank v. City T. S. D. & S. Co.*, 114 Fed. 529, 52 C. C. A. 313; *Henningsen v. U. S. F. & G. Co.*, 143 Fed. 810, 74 C. C.

A. 484. This is but another way of stating the rule laid down by the Washington court that the money to be paid under the contract was the very money the payment of which to the laborers and materialmen was secured by the bond. If the surety has such a lien upon the money in the hands of the city, he must retain such lien or equity in the money as far as it can be clearly traced, which the courts will protect until it is borne down by some other superior equity, and in a case of the character where, upon principles analogous to those controlling the marshaling of securities, the creditor may not realize upon such security and, over the objection of a bondsman having a potential equity in such security, apply it to an unsecured debt, depriving the bondsman of all benefit from it and hold said bondsman for the secured debt."

And also Judge Cushman states that he feels concluded by the decision of the Supreme Court of the United States and the decisions of this Circuit, even though it be contrary to the decision of the Supreme Court of the State of Washington, for, at page 631, he says:

"In *First National Bank v. City Trust, Savings Deposit & Security Co.*, 114 Fed. 529, 52 C. C. A. 313, the Circuit Court of Appeals for this circuit, upon the question of the right of subrogation of the surety to a lien upon the money held by the city to pay for work under

a contract, declined to acknowledge as controlling the decision of the Supreme Court of the State of Washington. *Dowling v. City of Seattle*, 22 Wash. 592, 61 Pac. 709. The Circuit Court of Appeals held that it was bound by a contrary doctrine. *Prairie State Nat'l Bank v. United States*, 164 U. S. 227, 17 Sup. Ct. 142, 41 L. Ed. 412. Under such circumstances, the court found the case to fall within an exception to the general rule, which rule would render controlling the state's decision on a question as to the public policy of the state."

III.

A similar state of facts arose in the case of *Illinois Surety Co. v. City of Galion*, 211 Fed. 161, where Judge Day says:

> "The equity of the surety company is superior to that of the bank advancing this money to the contractor, and the surety company is subrogated to the rights of the contractor, but the bank is not. *Henningsen v. United States Fidelity & Guaranty Co.*, 208 U. S. 404, 28 Sup. Ct. 389, 52 L. Ed. 547; *Prairie State Bank v. United States*, 164 U. S. 227, 17 Sup. Ct. 142, 41 L. Ed. 412; *Hardaway v. National Surety Company*, 150 Fed. 465, 80 C. C. A. 283; *United States v. Rundle*, 107 Fed. 227, 46 C. C. A. 251, 52 L. R. A. 505. It was the business of this bank to loan money, and not, as a national bank, to supply labor and material, to a contractor."

In re. Scofield Co., 215 Fed. 45, the Circuit Court of Appeals for the Second Circuit, held in conformity with the decisions hereinabove quoted. In that case, the question arose as to whether the surety on the bond, for the performance of public work, was entitled to a prior claim against the contract price, in the hands of the Government unpaid to the contractor, to reimburse itself for moneys paid or for claims filed against the bond in preference to the claims of general creditors in bankruptcy. The Court says, at page 50:

> "When the Fidelity Company assumed the obligation of suretyship its equity at once commenced with its obligation to see that the Scofield Company duly performed all the obligations which the contract with the government imposed upon it, including its obligations to promptly pay the laborers and materialmen. The Supreme Court in *Prairie State Bank v. United States*, 164 U. S. 227, 233, 17 Sup. Ct. 142, 41 L. Ed. 412 (1896), held that a stipulation in a building contract for the retention until the completion of the work of a certain portion of the consideration is as much for the indemnity of him who may be guarantor of the performance of the work as for him for whom the work is to be performed, and that it raised an equity in the fund to be created. In accordance with this doctrine the equity of the Fidelity Company in this reserved fund cannot be successfully questioned. And the fact is

quite immaterial that the contract which the Scofield Company made with the government provided simply for the retention of the fund until the completion of the work. A similar provision existed in the contract in the Prairie State Bank Case, but that fact did not prevent the Supreme Court from regarding the reserved fund as withheld for the benefit of the surety, as well as for the protection of the government. The doctrine of that case was reasserted by the Supreme Court in *Henningsen v. United States Fidelity & Guaranty Co.*, 208 U. S. 404, 28 Sup. Ct. 389, 52 L. Ed. 547 (1908). These cases show that the equity of the surety who pays the debts arising under the contract will take precedence of any assignment of funds due from the government made by the contractor."

IV.

Plaintiff and appellant frankly admits that there is a direct conflict between the federal decisions above relied upon by the appellant and the decisions of the Supreme Court of the State of Washington on the same facts. The Supreme Court of the State of Washington holds that the surety is only entitled to the reserved percentages provided in the contract as obligatory reservations by the municipality of payments to be made to the contractor until the full performance of the contract, and any other funds, except the obligatory reservations, are, according to the Washington Supreme

Court, assignable by the contractor to any person whomsoever. This practice has led to serious hardship to the claimants who have furnished labor and materials in public work, especially where the bond is not sufficient to protect all claims, and lays the door wide open for fraud on the part of dishonest contractors who, upon the representation that they are borrowing money for the purpose of carrying on the work under the contract, can obtain from a banker a large payment on the strength of the assignment to the banker of the sums to become due under the contract.

We submit that both judges in the District of Western Washington should conform to this court's rulings.

SURETY IS ENTITLED TO HAVE FUNDS SO DISPERSED AS TO PROTECT IT FROM LOSS.

No question has been raised upon the hearing below as to the right of the plaintiff to prosecute this suit before it had in fact made payment to the claimants who furnished labor and materials.

In *American Waterworks & Guarantee Co. v. Home Water Co.*, 115 Fed. 171, at page 182, the Court makes the following quotation:

> "'A court of equity will also prevent injury in some cases by interposing before any actual injury has been suffered, by a bill which has sometimes been called a bill *quia timet*, in analogy to proceedings at the common law,

where in some cases a writ may be maintained before any molestation, distress, or impleading. Thus a surety may file a bill to compel the debtor on a bond in which he has joined to pay the debt when due, whether the surety has been actually sued for it or not; and upon a covenant to save harmless, a bill may be filed to relieve the covenantee under similar circumstances.' *Redes*, Pl. 148, cited and followed by the Supreme Court in *City of New Orleans v. Christmas*, 131 U. S. 191-212, 9. Sup. Ct. 745, 33 L. Ed. 99; *Story, Eq. Jur.*, Sec. 826."

See also

Illinois Surety Co. v. City of Galion, 211 Fed. 161.

Thompson v. Fairbanks, 196 U. S. 516, 49 L. Ed. 577.

In re Rochford et al., 124 Fed. 182, Judge Sanborn, at page 187, says:

"The jurisdiction to inquire and determine who the lawful owners of it (the fund in court) are, and to that end to call before it all claimants by a reasonable notice or order to present their claims to the court within a reasonable time, or to be barred of any right or interest in the property in its cutody, or in its proceeds, is a power inherent in every court of equity, incidental and indispensable to the authority to administer the property in its possession and to distribute its proceeds."

The Code of the State of Washington provides

that a surety may compel an action to be brought against its principal. Remington's 1915 Code, Sec. 974, *et seq.* But this question is really academic in our present discussion, because by supplemental record it appears that the claims for labor and materials have been paid by the surety company and an assignment taken in favor of its manager.

His Honor, Judge Neterer, has attempted to distingnish the foregoing cases, decided by this Honorable Court, following the Prairie State National Bank case, upon the slightly varying facts differentiating this case from the other cases decided, but we submit that there is no distinction in principle, and that the decision of the trial court is completely at variance with the rule established by this court touching the right of the surety on public bonds to subrogation to funds in the hands of a municipality in preference to the right of the contractor or his assignee therein.

It must be borne in mind that in this particular case, the contract between the municipality and the contractor authorizes the city to withhold all sums in its hands until the labor and materials are paid. Under the general principles of suretyship, the surety would thus be entitled to have the city exercise its rights under the bond and to devote the money in its hands to the payment of the labor and materials entering into the work for which the money was especially appropriated rather than to repay a mere volunteer, like the bank, for moneys loaned to the contractor, even upon the credit, which

did not prevail in this case, of assignments made or promised to be made at or prior to the time the money was advanced by the bank.

A similar provision was found in the contract involved in *In re. Scofield Co.*, 215 Fed. p. 45, and there the Court, at page 48, says:

> "There is nothing in this record to indicate that the United States withheld the reserved percentages for the benefit of the subcontractors, unless such intention can be inferred from the language of the bond, which made it the duty of the contractor to pay promptly the subcontractors. The contract itself, in providing for withholding the percentages, does not state or explain the reason, at least so far as this record shows. It simply states that they may be withheld 'until the final completion and acceptance of the work'. This might seem to indicate that the purpose was simply to secure the government in case the work was not prosecuted promptly and faithfully, for the contract expressly provided that if for any of the reasons stated in the contract the United States found it necessary to terminate the contract, then it might deduct from the reserved percentages which it had withheld whatever sums it expended in completing the contract in excess of the stipulated price and it allowed certain other deductions to be made. And there was no authority given to pay any subcontractors or deduct from the reserved

fund any sums paid to any such persons. Nevertheless when the contract is construed in its entirety and in connection with the obligations imposed by the bond, it will be found that an equity was created in favor of the surety in the reserved fund to which it is the duty of this court to give effect."

We have quoted quite at length from this case *supra* and the entire case is illuminating in support of the plaintiff's contention in the case at bar.

We may state that in the case of *Los Angeles Rock & Gravel Co. v. Coast Construction Co.*, in the Superior Court of the State of California for Los Angeles County, the rule here contended for was applied by the court, but it seems hardly necessary for the plaintiff to cite decisions from state courts though they be at variance with the decisions of the Supreme Court of the State of Washington, inasmuch as we contend that the decisions of this Honorable Court are controlling, and the construction for which we contend has so long been the rule, especially by Your Honors, that it does not need supporting authority from state courts or other jurisdictions. We rely upon Your Honors' rulings in an unbroken line of decisions, and therefore insist that the decree of the lower court was erroneous and should be reversed, directing that the funds in the hands of the city be devoted to the payment of the materialmen and laborers, so far as same are necessary and in reimbursement to plaintiff of sums paid by it for completing the contract and in payment

of labor and materials, and the balance, if any, then paid to the bank upon its assignments.

WHEREFORE, we respectfully submit that the decree of the District Court for the Western District of Washington, Northern Division, should be reversed.

HASTINGS & STEDMAN,
KELLOGG & THOMPSON,
Solicitors for Appellant.

LIVINGSTON B. STEDMAN,
Counsel.

64 Haller Building, Seattle, Washington.